

Supreme Court, U. S.

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**IN THE
SUPREME COURT OF THE UNITED STATES**

OCTOBER TERM, A.D. 1976

No. 76-1082

IN THE MATTER OF:

**MEREDOSIA HARBOR & FLEETING SERVICE, INC.,
and RIVER ROAD MARINE REPAIR, INC.**

**FARMERS & TRADERS STATE BANK OF MEREDO-
SIA,**

Petitioner,

v.

ROBERT M. MAGILL,

Respondent.

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

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INDEX

Page

STATUTES:

- Sections 922 and 953, Title 46, United States Code (United States Shipping Act, Sections 911, *et seq.*, Title 46, United States Code) 2, 3
- Section 60 of the Bankruptcy Act, Title 11, Section 96, United States Code 4

CASES:

- Detroit Trust v. The Barlum*, 293 U.S. 21, 38, 55 S.Ct. 31, 79 L.Ed. 176 (1934) 8

TREATISE:

- Gilmore & Black, *The Law of Admiralty*, Foundation Press, Brooklyn, New York (1970) 7

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**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

**a. THIS CASE IS REPORTED IN: 545 F. 2d 583
(1976).**

b. GROUNDS FOR JURISDICTION:

i. The date of judgment: November 8, 1976.

ii. Stay of Mandate denied, Court of Appeals, December 2, 1976; Application for Stay of Mandate, United States Supreme Court, denied, December 10, 1976, No. A-476.

iii. Statutory provisions conferring jurisdiction: Section 1254(1) of Title 28, United States Code.

c. JURISDICTION OF FEDERAL COURT IN FIRST INSTANCE: Article III, Section 2, United States Constitution; §1334, Title 28, United States Code.

d. QUESTIONS PRESENTED FOR REVIEW:

1. Is "good faith in fact" a requirement of §922(a)(3) of Title 46, United States Code?

2. Where a full and fair consideration is given by a Mortgagee of a Preferred Ships Mortgage, may the Mortgagee be charged with the bad faith of the Mortgagor, where the affidavit required by §922(a)(3) of Title 46, United States Code, is made by the Mortgagor?

e. STATUTES INVOLVED:

i. Section 922(a) and (b), Title 46, United States Code, (41 Stat. 1000; 49 Stat. 424; 75 Stat. 661)

Preferred Mortgages

"(a) A valid mortgage which at the time it is made, includes the whole of any vessel of the United States (other than a towboat, barge, scow, lighter, car float, canal boat, or tank vessel, of less than twenty-five gross tons), shall, in addition, have, in respect to such vessel and as of the date of the compliance with all the provisions of this subsection, the preferred status given by the provisions of section 953 of this title, if —

(1) The mortgage is endorsed upon the vessel's documents in accordance with the provisions of this section;

(2) The mortgage is recorded as provided in section 921 of this title, together with the time and date when the mortgage is so endorsed;

(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made,

in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel;

(4) The mortgage does not stipulate that the mortgagee waives the preferred status thereof; and

(5) The mortgagee is a citizen of the United States and for the purposes of this section the Reconstruction Finance Corporation shall, in addition to those designated in sections 888 and 802 of this title, be deemed a citizen of the United States.

"(b) Any mortgage which complies in respect to any vessel with the conditions enumerated in this section is hereafter in this chapter called a 'preferred mortgage' as to such vessel." . . .

ii. Section 953, Title 46, United States Code, (41 Stat. 1004):

Preferred maritime lien; priorities; other liens

"(a) When used hereinafter in this chapter, the term 'preferred maritime lien' means (1) a lien arising prior in time to the recording and indorsement of a preferred mortgage in accordance with the provisions of this chapter; or (2) a lien for damages arising out of tort, for wages of a stevedore when employed directly by the owner, operator, master, ship's husband, or agent of the vessel, for wages of the crew of the vessel, for general average, and for salvage, including contract salvage.

"(b) Upon the sale of any mortgaged vessel by order of a district court of the United States in any suit in rem in admiralty for the enforcement of a preferred mortgage lien thereon, all preexisting claims in the vessel, including any possessory common-law lien of which a lienor is deprived under the provisions of

section 952 of this title, shall be held terminated and shall thereafter attach, in like amount and in accordance with their respective priorities, to the proceeds of the sale; except that the preferred mortgage lien shall have priority over all claims against the vessel, except (1) preferred maritime liens, and (2) expenses and fees allowed and costs taxed, by the court."

iii. Section 60(a) and (b) of the Bankruptcy Act, Title 11, United States Code, §96(a) and (b) (reproduced in pertinent part):

Preferred creditors

"(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

• • •

"(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: Provided however, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in

which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction."

e. STATEMENT OF THE CASE:

This action was brought by the Petitioner as holder of the Preferred Ships Mortgage taken by the Petitioner on October 1, 1970 to secure advances made by the Petitioner Bank to the owner of the vessels upon which the Mortgage was taken. These advances were made to the owner of the vessels by withdrawals by the owner from a bank account at the Petitioner Bank and on uncollected funds which were subsequently dishonored by various drawee banks, resulting in overdrafts in the owner's bank account. These overdrafts developed eleven to twenty-one days prior to the taking of the Mortgage by the Petitioner. In all, the Petitioner advanced to the vessel owner the sum of \$170,000 and the Schuyler State Bank of Rushville advanced the amount of \$130,000, for a total of \$300,000, which amount was secured by the subject Preferred Ships Mortgage. For purposes of this case, and as disclosed by the record throughout, Petitioner herein in subrogated to the entire claim of the Schuyler State Bank. The trial court found the advance of \$300,000 to the vessel owner to be the result of a "check kiting scheme." There is no dispute that the Mortgagees suffered losses in the amount of \$300,000.

Reclamation Petitions were filed in the Bankruptcy Court seeking a recovery of the vessels, or in the alternative, the proceeds from the sale of the vessels. The Reclamation Petitions were based upon the subject Preferred Ships Mortgages held by the Petitioner. The Trustee filed

an Affirmative Defense in the nature of an action brought pursuant to §60 of the Bankruptcy Act, Title 11, United States Code, §96(a) and (b), to set aside the Mortgage as a preferential transfer.

At trial, the Petitioner raised as a defense, *inter alia*, that a Mortgage perfected by compliance with §922 of the Ships Mortgage Act, Title 46, United States Code, §922, is an allowable preference and intended by the Congress to be unassailable under §60 of the Bankruptcy Act, and further, that the properly perfected Preferred Ships Mortgage is entitled to the priority set out in §953 of the Ships Mortgage Act, Title 46, United States Code, §953.

The Bankruptcy Court found the Mortgage void. On Appeal, the United States District Court found the Mortgage voidable and properly set aside as a preferential transfer under §60 of the Bankruptcy Act, Title 11, United States Code, §96(a) and (b). An Appeal was taken to the United States Court of Appeals for the Seventh Circuit and a copy of the Court of Appeals' Opinion is hereinafter reproduced. The Court of Appeals found the Preferred Ships Mortgage vulnerable by an inquiry made into the Affidavit made in compliance with §922(a)(3) of the United States Shipping Act; more particularly, good faith in fact was held required and chargeable to the Mortgagee even though the Mortgagor had made the required Affidavit.

ARGUMENT

The lien of a Preferred Ships Mortgage may not be set aside, or its preferred status impaired, by an inquiry behind an affidavit filed in conformity with §922(a)(3) of the Ships Mortgage Act; an affidavit made in bad faith by the Mortgagor may not be charged to the Preferred Ships Mortgagee, where the Mortgagee has paid a full and fair consideration.

The Court of Appeals held that §922(a)(3) of Title 46, United States Code, "demands assurance that 'the mortgage is made in good faith'." The subsection reads that the mortgage shall have the preferred status given by §953 of Title 46, United States Code, if, *inter alia*:

"(3) an affidavit is *filed* . . . to the effect that the mortgage is made in good faith" (emphasis added)

The obvious purpose of the affidavit is to provide an alternative recourse to other creditors of a mortgagor who makes a Preferred Ships Mortgage in bad faith and with the intent to defraud other creditors. Such alternative recourse is necessary because the Preferred Ships Mortgage was intended by the Congress to be unassailable if the requirements of §922(a) are met. The Congress' intentions are succinctly summarized in Gilmore & Black, *The Law of Admiralty*, §9-48:

"In considering the mechanics of getting rid of the wartime fleet, the Congressional committees soon realized that large infusions of new capital would have to be pumped into the long moribund private shipping industry. That meant credit and the credit would have to come from the Government or the banks or both. In either case the lender would demand satisfactory security. Recognizing that much of the financing would

have to be done by the Government, but hoping that private capital could be induced to take its share, Congress incorporated in the Shipping Act of 1920 a statute to be known as the Ship Mortgage Act, whose purpose was to make private investment in shipping attractive as well as to protect the United States which would obviously be the principal source of credit."

The efficacy of the Preferred Ships Mortgage was before this Honorable Court in *Detroit Trust Co. v. The Barlum*, 293 U.S. 21, 38, 55 S.Ct. 31, 79 L.Ed. 176 (1934):

"Such a mortgage upon a vessel documented under the laws of the United States, the Congress has undertaken to regulate with respect to priority of lien. If the conditions so laid down are fulfilled, the mortgage is to be a 'preferred mortgage' with all the incidents which the Act attaches to it, including the right to bring foreclosure in admiralty. *To hold that a mortgage is not within the Act which the Act itself states is within it, is not to construe the Act but amend it.* The question of policy—whether different terms should have been imposed—is not for us. We may not add to the conditions set up by Congress any more than we can subtract from them. They stand as defined, precise and complete." (Emphasis added.)

The Court in *Barlum* was faced with the question of the application of ships mortgage loan proceeds. Compelling and salient observations were made:

"An examination of the provisions of the Act leaves no doubt that the subject of mortgages of vessels, and, in particular, the priority which should be assigned them in relation to other liens, was under the close scrutiny of the Congress in determining its policy. But, among all the minute requirements of the Act, we find none as to the application of the proceeds of loans which mortgages secure. . . . We are not at liberty to imply a condition which is opposed to the explicit terms of the statute." 293 U.S. 21, 37-38.

Relief to the Petitioner was not only denied by the finding that the required affidavit was not, *in fact*, made in good faith, but for the further reason that the Petitioner, as Mortgagee, was charged with the affiant's wrongdoing. Petitioner suffered losses in the amount of \$300,000 between September 10 and 20, 1970, only eleven to twenty-one days prior to receipt of the Mortgage by the Petitioner; consideration flowed to the Mortgagor as a result of a "check-kiting scheme." It is urged as patently unconscionable to charge the Mortgagee with bad faith for taking a Preferred Ships Mortgage on vessels sold for \$45,000 to secure a loss of \$300,000. That finding, on its face, has no basis in logic, reason, or fact.

The questions presented in this Petition are novel, but of great importance, which are here urged as of a character which have not, but ought be settled by this Court; Ships Mortgages are the subject of Treaties and the needs of the Maritime Commerce are succored by the intended security for investors in the shipping industry. Courts of seafaring nations throughout the world are called upon to determine the priorities of maritime liens. The decision of the Court of Appeals has armed every detractor of any Preferred Ships Mortgage with the means to strike swiftly and fatally behind the heretofore invincible shield provided by the Congress. Unless checked by this Court, an intended safeguard of the Maritime Commerce has suffered a new and far reaching vulnerability. None of the parties to this case, nor the courts below, received any guidance from any reported decision on the precise questions presented here. An important question of the intent of Congress is presented and the vulnerability of Preferred Ships Mortgages everywhere is at stake. The law will otherwise be made at each trial of a Preferred Ships Mortgage, and having been made, will expire, with little or no guidance

for the wary investor. He may well be denied the security Congress intended.

CONCLUSION

Petitioner submits that the judgment of the Seventh Circuit Court of Appeals is erroneous on its face, that the requirements of §922(a)(3), Title 46, United States Code, were not construed but improperly amended by the sanction of the inquiry into the state of mind of the affiant, and further, that the conclusion of bad faith on the part of the Mortgagee/Petitioner is without foundation in law, logic, reason or fact. The decision departs from the requirements of the statute and thereby thwarts the underlying policy and rationale of the Ships Mortgage Act. The implications are momentous.

I pray this Honorable Court grant this Petition and issue a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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In the
United States Court of Appeals
For the Seventh Circuit

No. 76-1018

In the Matter of:

MEREDOSIA HARBOR & FLEETING SERVICE, INC. and RIVER ROAD
MARINE REPAIR, INC.

FARMERS & TRADERS STATE BANK OF MEREDOSIA,
Lien Claimant-Appellant,

v.

ROBERT M. MAGILL,

Trustee-Appellee.

Appeal from the United States District Court for the
Southern District of Illinois.
Nos. S-BK-70-1365, 1366—HARLINGTON WOOD, JR., Judge

ARGUED SEPTEMBER 17, 1976—DECIDED NOVEMBER 8, 1976

Before FAIRCHILD, *Chief Judge*, CUMMINGS and TONE,
Circuit Judges.

CUMMINGS, *Circuit Judge.* This case arises from the denial of two Illinois banks' petitions to reclaim two vessels, allegedly subject to a maritime mortgage, or the proceeds from their sale in the hands of the bankruptcy trustee of the corporate mortgagor.

In 1970, John D. Rasco formed two companies, viz., Meredosia Harbor & Fleeting Service, Inc. and River Road

Marine Repair, Inc., its wholly owned subsidiary, to build and repair boats. During that year, the corporations were building the *Mary Ann*, a river towboat, and the *Anita Marie*, a harbor towboat.

In early 1970, Rasco engaged upon a fraudulent scheme to obtain funds from appellant Farmers & Traders State Bank of Meredosia (Meredosia Bank) and its subrogor, Schuyler State Bank of Rushville (Rushville Bank). Rasco opened checking accounts in the corporate names and in his own name in those banks and in another Illinois bank and an Oklahoma bank. During the summer of 1970, he commenced kiting checks among the various banks. The kite was discovered by bank examiners in auditing the Meredosia Bank in early September 1970. Because of the check kite and Rasco's own unsecured borrowings on his account and on each corporation's account from the Meredosia and Rushville Banks, the Meredosia Bank lost \$170,000 and the Rushville Bank \$130,000.

Neither of Rasco's corporations ever had any paid-in capital, and neither issued any stock. Both corporations were insolvent in early September 1970. The Meredosia Bank was aware of Rasco's check kiting as early as July 1970, and the Rushville Bank realized in early September 1970 that Rasco was insolvent and in an overdraft position. There was evidence of connivance between some of the bank officers and Rasco.

On October 1, 1970, River Road Marine Repair, Inc., pursuant to the banks' demand, mortgaged the *Mary Ann* and the *Anita Marie* to the banks to secure the indebtedness of \$300,000, consisting of \$170,000 cash previously advanced by the Meredosia Bank and 130,000 cash previously advanced by the Rushville Bank. Attached to the mortgage was Rasco's October 1, 1970, affidavit stating that the mortgage was made by Rasco as president of River Road Marine Repair, Inc.,

"in good faith without any design to hinder, delay or defraud any existing or future creditor of the mortgagor (shipowner) or any lienor of the vessel

mortgaged; and that this affidavit is made pursuant to the order of the Board of Directors of said corporation."

Both vessels were incomplete on October 1.

On November 6, 1970, the mortgagor River Road Marine Repair, Inc. and Rasco's other corporation, Meredosia Harbor & Fleeting Service, Inc., filed reorganization petitions under Chapter XI of the Bankruptcy Act. On the same day, they filed petitions to consolidate their Chapter XI proceedings. Consolidation orders were entered the same day by the bankruptcy referee and Alonzo Sargent was appointed as their receiver.

On November 20, 1970, the receiver sent a notice to all the creditors listed in the debtor's schedule of creditors, fixing the time and place for the first meeting of creditors and for various subsequent hearings. As sent out, the notice specified that the last date to file claims was June 14, 1971. The final paragraph of the notice referred to the fact that River Road Marine Repair, Inc.'s petition for arrangement had been consolidated with that of Meredosia Harbor & Fleeting Service, Inc. and that the cases were to proceed under one title, viz., In the Matter of Meredosia Harbor & Fleeting Service, Inc., No. S-BK-70-1365. The receiver's summary of liabilities and assets of the consolidated debtors attached to the notice unrealistically valued the *Mary Ann* at 450,000 and the *Anita Marie* at \$135,000. The debtors' personal property schedule filed by Rasco on December 14, 1970, listed the *Mary Ann*'s incomplete value as "unknown" and the *Anita Marie*'s incomplete value as \$80,000. Rasco listed corporate debts of \$504,350.08 and \$59,132.65, or a grand total of \$563,482.73.

In the consolidated proceeding, an adjudication of bankruptcy was entered on January 4, 1971, and receiver Sargent was appointed as trustee. Ten days thereafter, the trustee petitioned for leave to sell both unfinished vessels and other property of the consolidated bankrupts. On the following day, the referee in bankruptcy sent a notice to the creditors to show on or before January 25, 1971, why the

property should not be sold. On June 25, 1971, he authorized the sale of the bankrupts' property, there having been no contest to the January 15 show cause order. On December 14, 1971, he approved the trustee's sale of the *Anita Marie* for \$21,500. A month thereafter, he approved the sale of the *Mary Ann* and other miscellaneous personal property of the bankrupt for \$25,000.

On February 7, 1973, the Meredosia Bank filed an objection to the trustee's January 2, 1973, final report, indicating that it had a maritime mortgage for the two vessels for \$300,000, and stating that the trustee's counsel had previously advised the bank that the proceeds of the sale of the two vessels would not be expended until it was determined whether the mortgage was a valid lien. In March 1973, the Meredosia Bank filed a petition to reclaim the vessels or the proceeds of their sale, and a similar reclamation petition was filed in June 1973 by the Rushville Bank.

On May 1, 1974, the bankruptcy referee overruled the Meredosia Bank's objections to the final account of the trustee¹ and denied both banks' reclamation petitions. At the same time, he entered supporting findings of fact, conclusions of law and an opinion. In his opinion, the referee noted that the October 1, 1970, mortgage was given for an antecedent debt of \$300,000 caused by Rasco's check-kiting scheme. He observed that the bankrupts were hopelessly insolvent at the time of the mortgage transaction. He held that the mortgage on the towboats was void as a preference. He also held that the mortgage was invalid for want of a proper supporting affidavit and because each boat was incomplete when the mortgage was executed. Consequently, both banks' claims were only allowed as general claims.

On October 23, 1975, the district court rendered a thorough opinion affirming the referee's order. Judge Wood held that the banks never possessed a valid preferred

¹ On May 30, 1972, the referee appointed Robert M. Magill as successor trustee to the late Alonzo Sargent.

ship's mortgage because the supporting affidavit was not made in good faith. He also held that the banks had only a voidable preference because they had reasonable cause to believe that the mortgagor River Road Marine Repair, Inc. was insolvent at the time of the mortgage. Other contentions of the banks were overruled. We affirm.

The Meredosia bank insists that the bankruptcy court had no jurisdiction to consider the preferred mortgage the banks assertedly obtained on the two vessels under the Ship's Mortgage Act of 1920 (46 U.S.C. § 911 *et seq.*). The bank maintains that only a federal district court, a court with original jurisdiction in admiralty, may question the validity of a preferred ship's mortgage.² However, in the consolidated proceedings involving the mortgagor River Road Marine Repair, Inc., the consolidated debtor was adjudicated bankrupt on January 4, 1971. By that act, the property of the bankrupt passed into the custody of the bankruptcy court. 2 Collier on Bankruptcy ¶ 23.04 (14th ed. 1974). Having first secured custody of the vessels, the bankruptcy court was entitled to retain possession and determine all lien claims asserted against the vessels. 1 Collier on Bankruptcy ¶ 2.10 at 180-181 (14th ed. 1974).³ Thus the referee in bankruptcy properly reached the validity of the maritime mortgage.

² Since we find *infra* that the October 1 mortgage was not a preferred ship's mortgage under 46 U.S.C. § 922(a), the exclusive original jurisdiction granted to the federal district courts "[u]pon the default of any term or condition of the mortgage" under 46 U.S.C. § 951 for "preferred mortgages" is not applicable. Thus for purposes of our jurisdictional analysis, only more general maritime law principles need be examined to determine whether the bankruptcy court was ousted of its jurisdiction.

³ Appellant argues that the lien attached to the towboats *qua* towboats and not as species of the bankrupt's property. This argument claims that since a ship and its owner are sometimes distinct juridical entities in admiralty, a bankruptcy court cannot be in constructive possession of the bankrupt's ship. Despite a penchant for esoterica in the law of admiralty, appellant's construct proves too much. Since the bankruptcy court has the power to restrain an admiralty action *in rem* against a ship in the court's control, In

(Footnote continued on following page)

An otherwise valid ship's mortgage is granted the preferred status given by 46 U.S.C. § 953⁴ only if the conditions of 46 U.S.C. § 922(a)⁵ are met. Here the bankruptcy court

³ *Continued*

re *J. S. Gissel & Co.*, 238 F. Supp. 130 (S.D. Tex. 1965), the court also has power to adjudicate the status of claims before it. See generally *Gilmore & Black, The Law of Admiralty* 806-817 (2d ed. 1975).

⁴ Section 953 provides:

"(a) When used hereinafter in this chapter, the term 'preferred maritime lien' means (1) a lien arising prior in time to the recording and indorsement of a preferred mortgage in accordance with the provisions of this chapter; or (2) a lien for damages arising out of tort, for wages of a stevedore when employed directly by the owner, operator, master, ship's husband, or agent of the vessel, for wages of the crew of the vessel, for general average, and for salvage, including contract salvage.

"(b) Upon the sale of any mortgaged vessel by order of a district court of the United States in any suit in rem in admiralty for the enforcement of a preferred mortgage lien thereon, all preexisting claims in the vessel, including any possessory common-law lien of which a lienor is deprived under the provisions of section 952 of this title, shall be held terminated and shall thereafter attach, in like amount and in accordance with their respective priorities, to the proceeds of the sale; except that the preferred mortgage lien shall have priority over all claims against the vessel, except (1) preferred maritime liens, and (2) expenses and fees allowed and costs taxed, by the court."

⁵ Section 922(a) provides:

"A valid mortgage which at the time it is made, includes the whole of any vessel of the United States (other than a towboat, barge, scow, lighter, car float, canal boat, or tank vessel, of less than twenty-five gross tons), shall, in addition, have, in respect to such vessel and as of the date of the compliance with all the provisions of this subsection, the preferred status given by the provisions of section 953 of this title, if —

"(1) The mortgage is endorsed upon the vessel's documents in accordance with the provisions of this section;

"(2) The mortgage is recorded as provided in section 921 of this title, together with the time and date when the mortgage is so endorsed;

(Footnote continued on following page)

refused to give preferential status to the banks' maritime lien because Rasco's accompanying affidavit that the mortgage was "made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel", as required by Section 922(a)(3), was itself made in bad faith. The banks would have use construe Section 922(a)(3) in a *pro forma* manner, viz.: once the affidavit is made the Section's requirement is met without more. If the affidavit is fraudulent, the appellants argue that recourse should be had against the affiant rather than the mortgage. We disagree. The Section 922(a)(3) affidavit requirement demands assurance that the "mortgage is made in good faith." The good faith requirement applies to the mortgage transaction. This creates, in turn, a derivative good faith requirement for the mortgagee. Upon a showing that the mortgagee knew of the mortgagor's bad faith, such knowledge will trigger Section 922(a)(3). Since each of the requirements of Section 922(a) is independently necessary for a ship's mortgage to attain preferred status, the mortgagee's bad faith will defeat a mortgage's aspiration towards preferred status.

The district judge marshalled nine factors based on the evidence that negated this good faith requirement:

Representatives of both banks agreed on the mortgage.

At the time the mortgage was arranged, bankruptcy was contemplated by all parties.

⁶ *Continued*

"(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel;

"(4) The mortgage does not stipulate that the mortgagee waives the preferred status thereof; and

"(5) The mortgagee is a citizen of the United States and for the purposes of this section the Reconstruction Finance Corporation shall, in addition to those designated in sections 888 and 802 of this title, be deemed a citizen of the United States."

The mortgage was agreed upon after the large overdraft developed.

Rasco paid off officers of both banks to help get loans approved.

As of September 1, 1970, Rasco admits his liabilities were larger than his assets.

Duesterhaus, an employee of the Bank of Meredosia in the loan department, heard of the check-kiting scheme in the latter part of September when the IRS and FBI conducted an investigation.

Duesterhaus notified Thormahlen and Westphal (President and Vice President of the Bank of Meredosia) as to the overdraft. They replied that Westphal knew what was going on.

Pezman, Chairman of the Board of Schuyler State Bank, first questioned the solvency of Rasco around September 10th or 11th and thereafter "it began to snowball."

William Stephens, President of Schuyler State Bank, decided Rasco was insolvent long before "it broke."

In light of this evidence, the court correctly held that the ship's mortgage did not attain preferred status under Section 922(a).⁶ Since the mortgage did not acquire "preferred status" under Section 922(a), the banks obtained no statutory lien on the vessels under 46 U.S.C. § 953. Therefore, Section 67(b) of the Bankruptcy Act (11 U.S.C. § 107(b)),⁷ which preserves statutory liens from the void-

⁶ We need not consider another reason to defeat preferred status advanced by the referee, i.e., the vessels were incomplete and had fraudulent documentation when the mortgage was executed, so that the mortgage did not include "the whole of any vessel of the United States" or the documentation required by Section 922(a).

⁷ Section 67(b) provides:

"The provision of section 96 of this title [Section 60 of the Bankruptcy Act] to the contrary notwithstanding, statutory

(Footnote continued on following page)

able preference provision of Section 60 (11 U.S.C. § 96), was inoperative.⁸

The trustee asserts that the bankrupt made a preferential transfer, which was voidable by the trustee under Section 60. The elements of a prima facie showing of a voidable preference under Section 60(a)(1)⁹ (11 U.S.C. § 96(a)(1)) are: (1) a debtor making or suffering a transfer of his property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt thereby resulting in the depletion of the estate; (4) while insolvent; and (5) within four months of bankruptcy; (6) the effect of which transfer will be to enable the creditor to obtain

⁹ *Continued*

liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or to any State or any subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition initiating a proceeding under this title by or against him. Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require the liens to be perfected by the seizure of property, they shall instead be perfected by filing notice thereof with the court."

⁸ The district judge also held Section 67(b) inapplicable because any lien obtained by the banks was made by agreement and therefore not a "statutory lien" as defined in Section 1.29(a) of the Bankruptcy Act (11 U.S.C. § 1.29) and as used in Section 67(b). Since the banks had obtained no valid lien on the vessels, this point need not be decided on appeal either.

⁹ Section 60(a)(1) provides:

"A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

a greater percentage of his debt than some other creditors of the same class. The banks maintain that a prima facie showing of a Section 60 voidable preference has not been made on the ground that several of the required elements are not satisfied.

First, appellant argues as a matter of due process that because the towboats were owned by River Road Marine and because the caption of the bankruptcy adjudication was "Merodosia Harbor & Fleeting Service, Inc." only Merodosia was adjudicated bankrupt, so that the transfer of the boats by River Road Marine was not by the debtor. Appellant's argument has no merit. The Merodosia Bank contends that no notice of the November 6, 1970, consolidation of the two reorganization petitions was given to creditors and that therefore River Road Marine Repair, Inc., the mortgagor, cannot be deemed as having been derivatively adjudicated bankrupt. This is refuted by the record. The consolidation was at the request of each Rasco corporation. The November 20, 1970, notice to all creditors called their attention to the November 6th consolidation order and advised that both cases would proceed under the name of the parent Merodosia Harbor & Fleeting Service, Inc. Because of the consolidation, the bankruptcy adjudication of the parent on January 4, 1971, covered its wholly-owned and jointly-operated subsidiary," River Road Marine Repair, Inc. If the bank wished to object to the consolidation, its counsel was present at the time of the consolidation order and should have objected at that time.

Second, the Merodosia Bank disagrees that the mortgage was to secure an antecedent debt. It is true that when a creditor takes and perfects security from an insolvent debtor, he does not receive a voidable preference if consideration was given by the creditor for the security in the form of a loan. 3 Collier on Bankruptcy ¶ 60.19 (14th ed. 1974). But here no new money was lent to the debtor. Rather, the mortgage was for an antecedent debt to the

¹⁰ River Road Marine Repair, Inc.'s petition for consolidation described it as the wholly-owned subsidiary of Rasco's other corporation.

banks of \$300,000 stemming from the check-kiting scheme. Appellant claims that the overdrafts permitted between September 10 and September 20, 1970, were allowed on the strength of the already negotiated and agreed upon but not yet issued mortgage. However, both the district judge's and our review of the record indicates that only when the bank examiners' investigation made it necessary to cover the banks' overdraft position did the banks and Rasco consider and approve the ship's mortgage." Therefore, the mortgage secured an antecedent debt.

Third, the bank argues that insufficient evidence was adduced at the hearing before the referee to support a finding of insolvency-in-fact at the time of the making of the mortgage. The appropriate definition of insolvency is given by Section 1(19) of the Bankruptcy Act (11 U.S.C. § 1(19)):

"A person shall be deemed insolvent within the provisions of this title whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts."

The district judge outlined five excerpts from the record demonstrating insolvency under this standard:

Mr. Rasco testified that at the time the mortgage was granted, the probability of bankruptcy had been discussed.

Mr. Rasco testified that as of September 1, 1970, he believed that his liabilities were greater than his assets.

Eugene Estes, a CPA, testified that both corporations were insolvent during September.

William C. Stephens, President of Schuyler State Bank, decided Rasco was insolvent long before "it broke."

¹¹ See, e.g., Tr. Vol. 1 at 61-62 (Rasco); Vol. 2 at 200-203 (Rasco); Vol. 5 at 85, 87 (Chrisman, Director of the Merodosia Bank).

Basil Humphrey, a CPA, testified that with hindsight the companies appeared to have been insolvent on October 1.

We agree with Judge Wood that the record demonstrates that the corporations were insolvent as of October 1, 1970, the date of the execution of the mortgage.

Accordingly, the requirements of Section 60(a)(1) were satisfied. The record shows¹¹ that at the time of the transfer the banks had "reasonable cause to believe that the debtor [was] insolvent" within the meaning of Section 60(b).¹² This preferential transfer was therefore voidable by the trustee, so that the proceeds from the sale of the vessels for some \$45,000 are now available for the debtor's general creditors.

The bank has also raised some objections in the nature of affirmative defenses to the prima facie showing of voidable preference. It relies on the two-year statute of limitations contained in Section 11(e) of the Bankruptcy Act

¹¹ See text immediately preceding note 6 *supra*.

¹² Section 60(b) provides:

"Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however*, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction."

(11 U.S.C. § 29(e)).¹⁴ That provision requires a trustee to sue on claims of the estate within two years of the bankruptcy adjudication. Thus appellant contends the trustee's voiding of the mortgage, even granted that it is a Section 60(a)(1) preference, is time barred. Section 11(e) is not applicable here where the trustee filed no suit on behalf of the debtor. Rather the lienholders asserted their claims against the trustee.¹⁵ As the bankruptcy referee observed, Section 11(e) "does not come into play when [the trustee] defends money in his hands from creditors whose claims would be preferential if successful." The trustee's defense was in the nature of recoupment and therefore not barred by Section 11(e). Cf. *Bull v. United States*, 295 U.S. 247, 262.

The bank also complains of trial misconduct before the bankruptcy referee. While the trustee's witness, accountant Estes, may have related to the bank's witness, accountant Humphrey, that the bankruptcy referee had a pre-trial "problem of check-kiting" and of "unjust enrichment," that does not show that the referee had prejudged the case.

Nor can we fault the referee for casually remarking that the refusal of two subpoenaed witnesses, Ernest Thor-mahlen and Harold Westphal, to testify on Fifth Amendment grounds was because "there's something they don't want to tell." The Fifth Amendment provides that "[n]o person . . . shall be compelled in any criminal case to be a witness against *himself*." (Emphasis supplied.) The Supreme Court has recently reminded us that:

"[d]espite its cherished position, the Fifth Amend-

¹⁴ In pertinent part, Section 11(e) provides:

"A . . . trustee may, within two years subsequent to the date of adjudication . . . , institute proceedings in behalf of the estate upon any claim against which the period of limitation fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy."

¹⁵ Of course, the trustee was not required to file a formal complaint to initiate the avoidance of the preference since the property in question was already within the bankruptcy court's jurisdiction. See 2 Collier on Bankruptcy ¶ 23.04(2) (14th ed. 1974).

ment addresses only a relatively narrow scope of inquiries. Unless the Government seeks testimony that will subject its maker to criminal liability, the constitutional right to remain silent absent immunity does not arise. An individual therefore properly may be compelled to give testimony, for example, in a non-criminal investigation of himself." *Garner v. United States*, . . . U.S. . . ., 44 LW 4323, 4326.

The self-incrimination privilege is a personal one. Thus the banks *qua* corporations may not claim the privilege against self-incrimination—with its derivative mandate not to comment on a person's decision to claim the privilege and remain silent (*Griffin v. California*, 380 U.S. 609)—on behalf of Thormahlen and Westphal.

Of course, a civil penalty cannot be imposed upon a witness' exercise of the privilege. *Lefkowitz v. Turley*, 414 U.S. 70; *Garrity v. New Jersey*, 385 U.S. 493. Since Thormahlen and Westphal together own 60% of the stock of the Meredosia Bank (appellant's brief at 25), a colorable argument might be made that any adverse innuendo drawn by the referee concerning their failure to testify which would contribute to voiding the preference and thereby the reduction of the banks' priority in the bankrupt estate and, derivatively, a reduction of the property eventually to be distributed to the officers as stockholders is a penalty against these bank officers.

We are not impressed by this tortured logic. The quintessential nature of a corporation is the corporate veil drawn between it and its shareholders. To the extent that the above argument can be read as describing the imposition of a penalty on Thormahlen and Westphal for asserting the self-incrimination privilege, such a "penalty" is too attenuated to come within the stricture of the *Garrity* line of cases. In any event, since bankruptcy is a civil proceeding, the comment on the two officers' silence by the referee operated as an example of individuals being "compelled to give testimony . . . in a non-criminal investigation of [themselves]." *Garner, supra*, . . . U.S. at . . ., 44 LW at

4326. In addition, Thormahlen's and Westphal's wrongdoing as it impacted on the bankruptcy proceeding was firmly and independently established elsewhere in the record."

Finally, since the district court and the bankruptcy referee credited Assistant United States Attorney Pilolla's statement to the referee that there was no reference to grand jury testimony during the proceeding before the referee and no contrary showing has been made, as a reviewing court we cannot sustain the bank's claim that grand jury tax transcripts were unlawfully used by the trustee and should have been turned over to bank counsel for cross-examination use.

We conclude that the appellant was not entitled to the \$45,000 proceeds of the sale of the vessels. Therefore, the district court's order of October 23, 1975, is affirmed.

A true Copy:

Teste:

.....
Clerk of the United States Court of
Appeals for the Seventh Circuit

" See, e.g., Trustee's Exhibits 1, 16; Bank's App. 138; Trustee's App. 3-5.

Supreme Court, U. S.

FILED

FEB 16 1977

MICHAEL RODAK, JR., CLERK

**IN THE
SUPREME COURT OF THE UNITED STATES**

OCTOBER TERM, A.D. 1976

No. 76-1082

Docketed February 4, 1977

IN THE MATTER OF:

**MEREDOSIA HARBOR & FLEETING SERVICE, INC.,
and RIVER ROAD MARINE REPAIR, INC.**

FARMERS & TRADERS STATE BANK OF MEREDOSIA,

Petitioner,

v.

ROBERT M. MAGILL,

Respondent.

**SUPPLEMENT TO
PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

**DUANE D. YOUNG
1027 South Second Street
P.O. Box 458
Springfield, Illinois 62705
Attorney for Petitioners**



SCHNEPP & BARNES PRINTERS, INC., SPRINGFIELD, ILL.

**IN THE
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**SUPPLEMENT TO
PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS
SOUTHERN DIVISION

IN THE MATTER OF:

MEREDOSIA HARBOR & FLEETING SERVICE, INC., being a consolidated case of:

MEREDOSIA HARBOR & FLEETING SERVICE, INC. and
RIVER ROAD MARINE REPAIR, INC.

FARMERS & TRADERS STATE BANK OF MEREDOSIA, an Illinois Banking Corporation, in its own right and as subrogee of the interests of SCHUYLER STATE BANK OF RUSHVILLE, an Illinois Banking Corporation,

Lien Claimant/Appellant,

vs.

ROBERT M. MAGILL,

Trustee/Appellee.

NO. S-Bk-70-1365
(Consolidated Nos.
S-Bk-70-1365 and
S-Bk-70-1366)

(APPEAL FROM
BANKRUPTCY
COURT)

ORDER

Petitioners/Lien Claimants, Farmers and Traders State Bank, Meredosia, and the Schuyler State Bank, Rushville, appealed to the District Court the Order of the Bankruptcy Judge entered on March 13, 1974. Thereafter, the issues were brief and orally argued and the pleadings and record examined by the Court.

The record reveals generally that the pertinent facts are as follows:

1. Meredosia Harbor and Fleeting Service, Inc., and River Road Marine Repair, Inc., are corporations fully controlled by John D. Rasco.

2. November 6, 1970: Both of the above corporations filed Chapter XI Petitions.

a. Both corporations moved for and secured an order of consolidation of the two cases.

(1) Notice on November 20, 1970, was given all creditors of the consolidation.

(2) Thereafter, both estates were administered under the case name Meredosia Harbor and Fleeting Service, Inc., No. S-Bk-70-1365.

3. On January 4, 1971, there was an adjudication of bankruptcy.

4. October 1, 1970: Assets of River Road Marine included two vessels, "Anita Marie" and "Mary Ann."

a. Rasco, on behalf of River Road, delivered to Farmers and Traders State Bank of Meredosia and to Schuyler State Bank of Rushville an instrument mortgaging the two vessels.

(1) The mortgages were issued by Rasco to cover large overdrafts, \$170,000 to the Schuyler State Bank and \$130,000 to the Farmers and Traders State Bank, which arose by virtue of the banks having credited River Road's account for checks that were subsequently dishonored.

b. The vessels were subsequently sold by the Trustee who now holds the proceeds pending the determination of the following issues:

(1) Whether the Bankruptcy Court had jurisdiction to determine the validity of liens perfected under the Ships Mortgage Act of 1920.

(2) Whether the lien of a Preferred Ships Mortgage is subject to a trustee's action, pursuant to Section 60 of the Bankruptcy Act, to set aside or avoid a preference.

(3) Whether 11(e) in any way bars the trustee from proceeding against the Preferred Ship Mortgage liens.

- (4) Whether River Road Marine and Meredosia Harbor were improperly consolidated under one case name.
- (5) Whether the Trustee proved that the mortgage was a preference and therefore void.
- (6) Whether unauthorized use of Grand Jury transcripts occurred at trial.

The above issues are considered individually as follows:

1. Issue

Whether the Bankruptcy Court had jurisdiction to determine the validity of liens perfected under the Ships Mortgage Act of 1920, 46 U.S.C. § 911, et seq.

Appellant banks assert that the validity of a Preferred Ships Mortgage lien perfected in accordance with the Ships Mortgage Act of 1920, 46 U.S.C. § 911, et seq. is not subject to the jurisdiction of a bankruptcy court. Appellants assert that only a court of admiralty can question the validity of a Preferred Ships Mortgage Lien. The Trustee, on the other hand, asserts that since the two ships in question were in the possession of the Bankruptcy Court, the Bankruptcy Court has exclusive jurisdiction to determine all controversies relating to the property and liens thereon.

The Referee held that:

As between courts of coordinate jurisdiction the first one obtaining the custody of the res is entitled to retain it and to determine the validity of all liens thereon and to set aside those liens obtaining within four months of bankruptcy. This court and not the Admiralty Court has the jurisdiction over the barges, and with the barges in its custody, has complete jurisdiction over those parties holding alleged liens in the barges.

Referee Contrakon was correct for the following reasons:

- a. The court of bankruptcy had possession of the boats

since upon the filing of a petition in bankruptcy, all the property of the alleged bankrupt passes into the custody of the court in bankruptcy. *Collier on Bankruptcy*, 14th Ed., Para. 23.04.

- b. Generally, where possession is established, the jurisdiction of the Bankruptcy Court is exclusive. *Collier on Bankruptcy*, 14th Ed., Vol. 2, Para. 23.04.
- c. Although there was a split of opinion in older cases, recent cases permit the court which has first secured custody of the property to retain possession and determine all the lien claims asserted against the vessel. *Collier on Bankruptcy*, 14th Ed., Vol. 1, Para. 2.10.
- d. Jurisdiction of the Bankruptcy Court extends to maritime lien claims. G. Gilmore and C. Black, *The Law of Admiralty*, Second Ed., 1975, p. 809-810.

2. Issue

Whether the lien of a Preferred Ships Mortgage is subject to a Trustee's action, pursuant to Section 60 of the Bankruptcy Act, to set aside or avoid a preference.

Appellants claim that they have complied with the requirements of Section 922 of the Ships Mortgage Act of 1920, 46 U.S.C.A. § 922, and thereby have created a Preferred Maritime Lien. They assert that Section 67(b) of the Bankruptcy Act, 11 U.S.C.A. § 107, bars any action by the Trustee pursuant to Section 60(a) and (b), 11 U.S.C.A. § 96.

I believe that the Trustee's power under § 60 to void liens is not barred in this case for the following reasons:

- (a) A preferred mortgage under the Ship Mortgage Act can qualify as a voidable preference under § 60:

A maritime lien must, like any other claim against an insolvent estate, run the gauntlet of the bankruptcy trustee's avoiding powers under Sections 60, 67 and 70

of the Bankruptcy Act. If a maritime lien arises out of a transaction which could have been avoided by the bankrupt's creditors as a fraudulent conveyance, it will be subject to avoidance by the Trustee in bankruptcy proceedings as it would be in admiralty proceedings. *If a ship mortgage is taken under circumstances constituting a voidable preference under § 60, it will be nonetheless a voidable preference for being a preferred mortgage under the Ship Mortgage Act.* G. Gilmore and C. Black, Jr., *The Law of Admiralty*, 2nd Ed., (1975) (Emphasis added.)

(b) A preferred mortgage under 46 U.S.C. § 922 may in fact not be present. Under 46 U.S.C. § 922(a)(3), an affidavit must be filed "to the effect that the mortgage is made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel." Based upon the transcript of the proceedings before the Referee, I would question whether the good faith requirement has in fact been satisfied. (See excerpts on Page 13.)

(c) Section 67(b) of the Bankruptcy Act, 11 U.S.C. 107(b) does not bar Trustee action under § 60.

Section 67 provides that statutory liens may be valid as against the Trustee even though arising within four months prior to the filing of a bankruptcy petition or perfected while the debtor is insolvent. Section 1(29a) of the Bankruptcy Act, 11 U.S.C.A. § 1 (29a) defines statutory lien as:

... a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute.

A lien is not a statutory lien if its creation is dependent

upon agreement by the parties to give security. *Collier on Bankruptcy*, 14th Ed., Para. 1:29a, p. 130.28; Para. 67.20.

In the present case, a preferred maritime lien is one dependent upon agreement by the parties. Therefore, the liens in this case are not statutory liens. Thus § 67(b) does not bar Trustee action under § 60.

3. Issue

Whether 11(e) in any way bars the Trustee from proceeding against the Preferred Ship Mortgage liens.

Appellants claim that the Trustee failed to file a mandatory complaint to initiate proceedings to set aside their lien under § 60 within the two year statute of limitations under § 11(d).

This position is for the following reasons without merit:

(a) Section 11(e), 11 U.S.C.A. § 29(e), in part provides:

... (a) trustee may, within two years subsequent to the date of adjudication . . . *institute proceedings in behalf of the estate* upon any claim against which the period of limitation fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy (Emphasis added.)

Section 11(e) applies only where the Trustee initiates suit on behalf of the estate. The Trustee did not initiate suit on behalf of the estate in the present case in regard to the ships in question as the Trustee had possession of the ships. On the contrary, the lienholders came into court and asserted their claims against the Trustee. As Judge Contrakon stated in his holding:

Section 11(e) comes into play when a Trustee for instance, seeks in a separate action to recover for the estate a preferential transfer of a res not in the jurisdiction of the bankruptcy court; but it does not come into play when he defends money in his hand from

creditors whose claims would be preferential if successful.

(b) The Trustee was not required to file a formal complaint to initiate proceedings.

Where the controversy concerns property in the actual or constructive possession of the Bankruptcy Court, the Court can exercise summary jurisdiction, and can adjudicate all rights and claims relating thereto. *Collier on Bankruptcy*, 14th Ed., Para. 23.04(2). The Trustee was not obligated to file a complaint to initiate proceedings to void appellants' lien claim since the property in question was already within the Bankruptcy Court's jurisdiction. On the contrary, appellants were given notice along with all creditors on November 20, 1970, by the Bankruptcy Court. Appellants came into court in their own behalf in June, 1973, to prove the validity of their claim and to contest the Trustee's final report.

4. Issue

Whether River Road Marine and Meredosia Harbor and Fleeting were improperly consolidated under one case — Meredosia Harbor and Fleeting Service, Inc., No. S-Bk-70-1365.

Appellants' claim that the consolidation was improper as the court did not give prior notice and a hearing to concerned creditors. In addition, appellants claim that River Road Marine was never adjudicated bankrupt.

(a) Appellants' due process claim is without substance.

Meredosia Harbor and Fleeting Service, Inc., and River Road Marine Repair, Inc., filed Chapter XI petitions on November 6, 1970. Each corporation simultaneously filed petitions to consolidate. The court entered a consolidation order on November 6, 1970. On November 20, 1970, all

creditors of the corporations received notice of the consolidation. Judge Contrakon in his opinion stated that the consolidation was only for expediency and no creditor was denied a right to assert a claim.

I do not believe that prior notice and hearing would be required in this setting since appellants may well have waived any due process right which might exist. No property right of any creditor is jeopardized by the procedure followed. Creditors received prompt notice of the consolidation order; however, there is no indication in the record that this point was raised prior to January, 1974, when appellants submitted a trial brief to the Referee. In fact, in his order, the Referee stated that the estates were administered as one with objection from no one. It is inappropriate for appellants at this point to suggest that prompt subsequent challenge on their part of the consolidation order would not have protected their interests.

(b) Appellants' claim that River Road Marine was never adjudicated bankrupt is without substance.

Both Meredosia Harbor and Fleeting and River Road filed petitions to consolidate. Both petitions state that the corporations have operated jointly and that River Road Marine is a wholly-owned subsidiary of Meredosia Harbor. On November 6th, the Court entered an order of consolidation under the name of Meredosia Harbor and Fleeting, as cause No. S-Bk-70-1365. The following notice of consolidation was given to creditors on November 20, 1970:

On November 6, 1970, River Road Marine Repair, Inc., filed its petition for an arrangement under Chapter XI of the Bankruptcy Act, case No. S-Bk-70-1366, and on November 6, 1970, an Order was entered that said River Road Marine Repair, Inc., be consolidated with Meredosia Harbor & Fleeting Service, Inc., and that these cases proceed under one case — Meredosia Harbor and Fleeting Service, Inc., No. S-Bk-70-1365.

Where two or more cases are pending in the same court by the same bankrupt, the court has discretion to order consolidation of the cases. Bankruptcy Rule 117(a) [derived from General Order 7]. The Advisory Committee Notes state that consolidation of cases implies unitary administration of the estate.

In this case, the Referee properly exercised his discretion to consolidate. Both the petitions by the bankrupt corporations and the record indicate that the two companies were operated jointly. In addition, the Referee, acting upon the request of the corporations stated in his opinion that consolidation was done in the interest of expediency. In *Stone v. Eachner*, 127 F. 2d 284 (4th Cir. 1942), the Court granted a motion for consolidation of a corporation and its wholly-owned subsidiary. Quoting a treatise by Latty, the Court stated:

Perhaps the fairest way of dealing with the situation when both the parent and the subsidiary corporation are insolvent is to let all the creditors of each share pro rata in the pooled assets of both. Such procedure would be especially equitable where the claimants are creditors of both the parent and the subsidiary. At 288.

This, in the present case the order of consolidation was an appropriate exercise of the Referee's discretion.

The fact that the bankruptcy proceedings were administered under the name of Meredosia Harbor alone is not important — especially in light of notice given to all creditors as to the consolidation.

5. Issue

Whether the Trustee proved that the mortgage on the barges was a preference and therefore void.

The elements of a preference under § 60(a) consist of the following: a debtor (1) making or suffering a transfer

of his property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt [resulting in a depletion of the estate], (4) while insolvent, and (5) within four months of bankruptcy, (6) the effect of which transfer will be to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class.

(a) The debtor made the requisite transfer of his property.

Appellants claim that since the barges were owned by River Road Marine and because River Road Marine never was adjudicated to be bankrupt, the requisite transfer *by a debtor* of property is not present.

As indicated above, River Road was properly consolidated with Meredosia and the order of bankruptcy applied to both corporations. Therefore, the requisite transfer is in fact present, i.e. by River Road.

(b) To or for the benefit of a creditor.

This element is not contested by appellants.

(c) For or on account of an antecedent debt resulting in depletion of the estate.

A transfer made in return for a consolidation which the transferor receives at the same time or thereafter is not a preference because not made for or on account of an antecedent debt. Thus, where a creditor takes and perfects security from an insolvent debtor he does not receive a voidable preference if consideration was given by the creditor for the security in the form of a loan. *Collier on Bankruptcy*, 14th Ed., Para. 60.19.

The overdrafts by River Road arose between September 10 and September 21, 1970. The secured mortgage was

issued on October 1, 1970. Appellants claim that the bank officers permitted the overdrafts on the strength of the already negotiated and agreed upon but not issued ship mortgages. Thus, appellants argue that an antecedent debt is not present since the creditor-banks obtained consideration in the form of the agreed upon mortgage in exchange for the overdrafts.

My reading of the record indicates that an antecedent debt is in fact present. The record indicates that the banks allowed the overdrafts to arise without prior consideration of obtaining security from Rasco. Only when it became necessary to cover their overdraft posture in the face of a bank examiner's investigation did the bank officers (from both banks) and Rasco consider and approve the ships mortgage. [See Transcript Vol. 1, pgs. 61-62, Rasco testimony.]; [Vol. 2, pgs. 200-203, Rasco testimony]; [Vol. 5, pgs. 85, 87, Chrisman testimony — director of Farmers and Traders Bank of Meredosia.] Thus, the record indicates that the overdraft constituted an antecedent debt. The issuance of the mortgages was preferential and depleted the estate.

(d) Whether the transfer was made while the debtor was insolvent.

In order for a preference to exist, a transfer of property must be made by the debtor while insolvent. Under § 1(19) a person is deemed to be insolvent whenever:

... the aggregate of his property, exclusive of any property which he may have conveyed transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, transfer or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts.

Appellants claim that the Trustee failed to demonstrate

that the corporations were insolvent as of October 1, 1970 — the date the mortgage was issued.

However, my opinion based upon the following excerpts from the record is that the corporations were bankrupt as of October 1, 1970:

- (a) Mr. Rasco testified that at the time the mortgage was granted, the probability of bankruptcy had been discussed. Vol. 1, pg. 56, 59.
- (b) Mr. Rasco testified that as of September 1, 1970, he believed that his liabilities were greater than assets. Vol. 2, pg. 35.
- (c) Eugene Estes, a CPA, testified that both corporations were insolvent during September. Vol. 3, pgs. 70, 71, 73, 74.
- (d) William C. Stephens, President of Schuyler State Bank, decided Rasco was insolvent long before "it broke."
- (e) Basil Humphrey, a CPA, testified that with hindsight the companies appeared to have been insolvent on October 1. Vol. 6, p. 50.

(f) Transfer within four months of bankruptcy.

This element is not contested by appellants.

(g) Whether the transfer enabled the creditor bank to obtain a greater percentage of its debt than some other creditor of the same class.

The test for this element under the Act is whether a creditor has obtained out of the bankrupt's property a greater percentage of his debt than some other creditor of the same class. Creditors, who, in the absence of preferences, are entitled to receive the same percentage upon their claims out of the estate of the bankrupt are members

of the same class. *Collier on Bankruptcy*, 14th Ed., Vol. 3, Para. 60.34.

Appellants claim that the record before the court on appeal contains no specific reference to any creditors other than the United States Government which claims a tax lien. Appellants state that the record only refers to all other creditors in the aggregate. Appellants then argue that since their Preferred Ship Mortgage has priority over the Federal Tax Lien, they are not creditors in the same class as the United States Government. In addition, appellants argue that the United States Government is not a creditor within § 60.

However, much of appellants' argument is moot as they do not possess a valid preferred ships mortgage. Every preferred ships mortgage must be supported by an affidavit. The affidavit must recite that the application for preferred mortgage status is made in good faith and without design to hinder, delay or defraud existing or future creditors. In light of the following excerpts from the record, this good faith requirement could not have been met.

- (a) Representatives of both banks agreed on the mortgage. Vol. 1, p. 52.
- (b) At the time the mortgage was arranged, bankruptcy was contemplated by all parties. Vol. 1, pgs. 56, 59; Vol. 2, p. 205.
- (c) Mortgage was agreed upon after the large overdraft developed. (See p. 11.)
- (d) Rasco paid off officers of both banks to help get loans approved. Vol. 1, pgs. 72-3, 78-80.
- (e) As of September 1, 1970, Rasco admits his liabilities were larger than his assets. Vol. 2, p. 35.

- (f) Duesterhaus, an employee of the Bank of Meredosia in the loan department, heard of the check kiting scheme in the latter part of September when the IRS and FBI conducted an investigation. Vol. 3, p. 105.
- (g) Duesterhaus notified Thormahlin and Westerphal (President and Vice President of the Bank of Meredosia) as to the overdraft. They replied that Westphal knew what was going on. Vol. 3, p. 101.
- (h) Pezman, Chairman of the Board of Schuyler State Bank, first questioned the solvency of Rasco around September 10 or 11th and thereafter "it began to snowball." Vol. 4, pgs. 113-114, 117.
- (i) William Stephens, President of Schuyler State Bank, decided Rasco was insolvent long before it broke. Vol. 4, p. 137.

Since the preferred ships mortgage is invalid, the banks are in the same class as other general creditors. The question is whether, as appellants claim, the record on appeal fails to specify additional general creditors.

Appellants admit in their brief that the record mentions "other creditors" in the aggregate. Affidavits written by Rasco listing creditors appear in the record before the court. Therefore, the record before the court sufficiently specifies additional general creditors.

Since the banks are members of a general creditors class, the transfer of the mortgage would have enabled the bank to obtain a greater portion of its debt than creditors in the same class or in a prior class. See *Collier*, Para. 60.34.

- (j) Whether the creditor banks had reasonable cause to believe that the debtor was insolvent.

Since the banks are members of a general creditor class, the transfer of the mortgage would have enabled the bank

to obtain a greater portion of its debt than creditors in the same class or in a prior class. See *Collier*, Para. 60.34.

(k) Whether the Creditor banks had reasonable cause to believe that the debtor was insolvent.

Section 60(b) provides that a preference as defined in 60(a) can be avoided by the trustee if the creditor receiving it, at the time the transfer was made, has reasonable cause to believe that the debtor is insolvent. Insolvency is defined in 1(19). Knowledge or actual belief of insolvency is not required; all that is required is a reasonable cause to believe that the debtor was insolvent at the time of the preferential transfer. *Collier*, Para. 60.53.

Based on the excerpts from the record already referred to, I believe the banks had reasonable grounds to believe the debtor was insolvent.

6. Issue.

Whether unauthorized use of grand jury transcripts occurred at trial.

Appellants point to the following exchange found at Vol. 4, pages 124-125, in support of their argument that grand jury minutes were wrongfully used:

"MR. BEIL: Now, for the record, please, I'd like the record to show that during the course of the cross examination of Judge Pezman, Mr. Pilolla, an Assistant District Attorney for this District, has been examining what appears to be a transcript of His Honor's testimony before the Grand Jury, and has had numerous conferences with the Trustee, who had been conducting the cross examination, and that cross examination was based in whole or in part, or could have been, on the basis of prior testimony.

"But that yesterday, when I requested the same courtesy and consideration, to have the transcript of

the testimony that Mr. Duesterhaus gave before the Grand Jury so I could use that in cross examination, it was denied.

"And I think — would like for the Court to take judicial notice of that fact and would like the record to so indicate the fact.

"REFeree COUTRAKON: I can't take judicial notice of it, haven't seen it, Mr. Beil.

"MR. BEIL: Is that true, Mr. Pilolla?

"MR. PILOLLA: Your Honor, I have no idea what his work papers are, and I would think that I would have the prerogative of keeping our working papers to ourselves. There has been no reference to Grand Jury testimony, at all."

This contention appears to be without substance.

Wherefore, the issues are found against appellants and the Referee's Order is affirmed. All other objections raised in the briefs and arguments are deemed to be without merit.

Enter this 23rd day of October, 1975.

/s/ Harlington Wood, Jr.
United States District Judge

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS
SOUTHERN DIVISION

IN THE MATTER OF:

MEREDOSIA HARBOR & FLEETING SERVICE, INC., being a consolidated case of:

MEREDOSIA HARBOR & FLEETING SERVICE, INC. and
RIVER ROAD MARINE REPAIR, INC.

FARMERS & TRADERS STATE BANK OF MEREDOSIA, an Illinois Banking Corporation, in its own right and as subrogee of the interests of SCHUYLER STATE BANK OF RUSHVILLE, an Illinois Banking Corporation,

Lien Claimant/Appellant,

vs.

ROBERT M. MAGILL,

Trustee/Appellee.

NO. S-Bk-70-1365
(Consolidated Nos.
S-Bk-70-1365 and
S-Bk-70-1366)

ORDER

The following coming on for determination, all of which have been heard and considered by this Court:

- A. Objections of Farmers and Traders State Bank of Meredosia, filed February 7, 1973, objecting to the final account of the Trustee;
- B. Petition by Farmers & Traders State Bank of Meredosia to reclaim property subject to maritime mortgage or the proceeds therefrom Trustee; filed herein March 23, 1973;
- C. Trustee's Affirmative Defense to objection to final report of Trustee and Reclamation Petition of Farmers & Traders State Bank of Meredosia, filed herein May 11, 1973;
- D. Trustee's Affirmative Defense to objection to final report of Trustee and Reclamation Petition of Farmers

& Traders State Bank of Meredosia, filed herein May 29, 1973;

- E. Petition to reclaim property, subject to maritime mortgage, or the proceeds therefrom, from Trustee, filed herein by the Schuyler State Bank on June 19, 1973;
- F. Motion to Dismiss Trustee's pleadings and evidence for delivery of property and other relief filed herein November 20, 1973, by the Farmers & Traders State Bank of Meredosia, Meredosia, Illinois, on November 20, 1973.

I.

Findings of Fact

1. The Bankrupt, Meredosia Harbor & Fleeting Services, Inc., and Riverroad Marine Repair, Inc. corporations, each fully controlled by John D. Rasco, filed Chapter 11 Petitions in this Court November 6, 1970. At that time it was moved and order made that the two cases be consolidated.

2. On November 20, 1970, notice was mailed to all creditors of the debtors, calling a first meeting of creditors, and to this notice was appended:

"On November 6, 1970, Riverroad Marine Repair, Inc. filed its petition for an arrangement under Chapter XI of the Bankruptcy Act, Case No. S-BK-70-1366, and on November 6, 1970, an order was entered that said Riverroad Marine Repair, Inc. be consolidated with Meredosia Harbor & Fleeting Service, Inc., and that these cases proceed under one case — Meredosia Harbor & Fleeting Service, Inc., No. S-BK-70-1365.

3. Thereafter, the two cases were administered as one, with no objection. This was done for expediency. No person was denied a hearing or any right whatsoever to press his claim because of the consolidation.

4. Neither of the corporations received any capital, nor contributions, from inception until date of bankruptcy.

5. On October 1, 1971, both corporations were insolvent and the Farmers & Traders State Bank of Meredosia and the Schuyler State Bank of Rushville were aware of the insolvency of the corporations. Both the Farmers & Traders State Bank of Meredosia and the Schuyler State Bank of Rushville were then aware that they had been victimized by a check-kiting scheme conceived and operated by John Rasco. Rasco conducted the check-kiting operation through the use of accounts in the name of the two corporations, which accounts were located in at least five banks, including the above-named banks. Following the bank examination by examiners at the Farmers & Traders State Bank of Meredosia during September, 1970, a phone call from National Boulevard Bank of Chicago on September 15th to an officer of the Schuyler State Bank of Rushville informing the bank that on that date \$120,800.00 checks drawn by Rasco were being returned, and conversations between the officers of the Schuyler and Meredosia banks, both banks were then aware of the apparent insolvency of the two bankrupt corporations. As a result both banks determined the amount of their respective losses resulting from the check-kiting scheme.

6. The bankrupt corporations were in fact insolvent on October 1, 1970, and no new capital was acquired by the corporations. From that point the assets of the bankrupt corporations depreciated rather than appreciated. On October 1, 1970, the Farmers & Traders State Bank of Meredosia demanded and received a note secured by the mortgage on the boats to attempt to secure its loss of \$170,000.00 from the check-kiting scheme. Likewise, the Schuyler State Bank on the same date demanded and received a note in the amount of \$130,000.00 secured by

the same mortgage on the boats to attempt to secure its loss in the check-kiting scheme.

7. The total assets of both bankrupt companies as of October 1, 1970, had a fair cash market value of less than \$70,000.00.

8. The total claims in both estates, exclusive of the subrogated claims of the insurance companies paid to the banks in connection with their losses, amount to \$401,356.64. Each of the bankrupt corporations had debts far in excess of \$70,000.00 on October 1, 1970. All debts on which claims were filed were received on or before October 1, 1970.

9. On the date of adjudication of the companies in bankruptcy, the Trustee of the estate had and retained full possession of the two boats subject of the mortgages, namely the ANITA MARIE and the MARY ANN, both of which were located at Meredosia, Illinois. These boats were then and remained in the custody of this Bankruptcy Court.

10. The ANITA MARIE was then in the water and approximately 95% complete. The MARY ANN was not in the water and was a partially completed hull with shafts, but engines, screws, rudder, steering mechanism, and living quarters were not installed. Both boats were incomplete when the mortgage was executed. Since the boats were not completed at the time the mortgage was executed and filed the documentation was fraudulent and the ships mortgage void.

11. The Trustee filed his petition to sell the two boats free and clear of all liens on January 14, 1971, and all creditors, both general and secured, were given new notice of the Trustee's petition for leave to sell.

12. A show cause order as to why the boats should not be sold free and clear of all liens was entered and legal

notice of the hearing was sent to each of the creditors, both general and secured, on January 15, 1971. Each of the creditors was ordered to show cause if any they had why the property could not be sold on or before January 25, 1971. Neither bank made objection to the sale. Order was entered ordering the vessels sold on June 23, 1971. Both banks consented to the sale, free and clear of liens, with the understanding that any liens against the vessels would be vacated at the time of their sale and that such liens as found out would attach with equal force to the proceeds of sale.

13. On January 2, 1973, the Trustee filed final account. On January 26, 1973, the Bankruptcy Court entered order for final meeting of creditors and all creditors were notified of the final meeting. On February 7, 1973, the Farmers & Traders State Bank of Meredosia filed objection to final report of Trustee.

14. On March 23, 1973, the Farmers & Traders State Bank of Meredosia filed a petition to reclaim the property subject to the maritime mortgage which had been previously sold by the Trustee. This was the first reclamation petition filed with respect to the two boats.

15. On May 11, 1973, the Trustee filed an affirmative defense to objection to final report of Trustee of reclamation petition of Farmers & Traders State Bank of Meredosia.

16. May 29, 1973, the Farmers & Traders State Bank of Meredosia filed reply to Trustee's May 11, 1973 affirmative defense.

17. On June 19, 1973, Schuyler State Bank of Rushville filed reclamation petition to reclaim the two boats or proceeds.

18. Thereafter, hearings were held and all parties presented their evidence.

PART II

CONCLUSIONS OF LAW

1. "Where possession (of the assets in question) is established to the satisfaction of the court (in bankruptcy), its jurisdiction is exclusive and it may proceed to determine controversies with respect to the property and the extent and character of liens thereon or rights therein." *Collier on Bankruptcy*, 14th Ed., Vol. 2, pg. 459.

2. As between courts of coordinate jurisdiction the first one obtaining custody of the res is entitled to retain it and to determine validity of all liens thereon and to set aside those liens obtained within four months of bankruptcy. This court and not the Admiralty Court has the jurisdiction over the barges in its custody, has complete jurisdiction over those parties holding alleged liens on the barges. Whether the creditor has filed a secured claim is wholly immaterial. An alleged lienholder must respond to show cause order or default. If he appears, the burden is upon him to prove his lien. *In Re Ripp* (CA — 7th; 1957) 242 F. 2d 849. *Collier on Bankruptcy*, 14th Ed., Vol. 2, pg. 459.

3. "Once the court acquires possession, the jurisdiction to determine all conflicting claims will remain, and there can be no interference with such possession upon the part of any other court except by way of review or appeal." *Collier on Bankruptcy*, 14th Ed., Vol. 2, pg. 461.

4. "Once consent to the summary jurisdiction of the bankruptcy court appears, that jurisdiction generally will be retained for the determination of all the claims of the parties and for the enforcement of all their rights against each other. Consent having been given it may not subsequently be withdrawn by a party, nor may the party, upon

appeal from the decision, raise the question of what of jurisdiction. Consent as hereafter demonstrated may be (1) express; (2) by waiver through failure to raise proper objection or (3) implied from any act indicating a willingness on the part of the party that his claim or interest be determined summarily by the bankruptcy court." See *Collier*, 14th Ed., Vol. 2, pgs. 533, 534.

5. "It should be remembered that as to property in its actual or constructive possession, or the proceeds thereof, the bankruptcy court has the exclusive (and summary) jurisdiction to determine the validity, amount and priority of all liens and encumbrances thereon. Thus, when the proceeds of the sale are before the court for distribution the lienors or encumbrancers will be entitled to such funds in the manner, amount and priority fixed by the bankruptcy court." See *Collier*, 14th Ed., Vol. 4, pgs. 1219, 1220.

6. "A claimant who consented to a sale by the trustee is bound by his consent and must assert his rights against the proceeds." *Collier Bros. v. Wiseman*, (CA 6th, 1957) 242 F. 2d 511, *Matter of Electric Specialty Co.*, 36 Am. B.R. (N.S.) 131.

7. "Sec. 60a. (1) A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class." See *Collier on Bankruptcy*, 14th Ed., Vol. 3, pg. 731. 60(b) "Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference

thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent." See *Collier*, 14th Ed., Vol. 3, pg. 734.

8. "The repayment to a bank of money obtained by depositing a worthless check and drawing checks against the credit so obtained is a preference voidable by a trustee in bankruptcy." *Abraham Kainberg, Trustee v. Springfield National Bank*, Appt. 103 A.L.R. 306.

9. "Delayed remittances, increase of loans, and overdrafts are so suggestive of financial embarrassment that a creditor receiving a transfer cannot ignore them." 9 Am. Jur. 2nd, pg. 808.

10. "A history of overdrafts and unpaid notes, in addition to the type of financial statements submitted and the nature of the financing of the bankrupt, were sufficient to call for inquiry by the bank which would have disclosed insolvency on the date of the preferential assignment to the bank." *Re Shelley Furniture, Inc.*, (CA7 Ill.) 283 F. 2d 540.

11. Title 46 Sec. 922 of the U.S. Code provides that a condition precedent to a preferred mortgage is

"(3) An affidavit is filed with the record of such mortgage to the effect that the mortgage is made in good faith and without any design to hinder, delay, or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel."

PART III

OPINION

Meredosia Harbor & Fleeting Service, Inc. and River Road Marine Repair, Inc., corporations, it appears formed to build river barges each fully controlled by John D. Rasco, filed Chapter XI petitions in this court on November

6, 1970. At the same time it moved for and secured an order of consolidation of the two cases. The banks now object to the consolidation which, they claim, was accomplished without notice to creditors.

On November 20, 1970, a notice was mailed to all creditors of the debtors, calling a first meeting of creditors and to this notice was appended:

On November 6, 1970, River Road Marine Repair, Inc. filed its petition for an arrangement under Chapter XI of the Bankruptcy Act, case No. S-Bk-70-1366, and on November 6, 1970, an Order was entered that said River Road Marine Repair, Inc. be consolidated with Meredosia Harbor & Fleeting Service, Inc. and that these cases proceed under one case — Meredosia Harbor & Fleeting Service, Inc., No. S-Bk-70-1365.

Thereafter the two estates were administered as one, with objection from no one. This was done only for expediency. No person was denied a hearing or a right to press his claim herein because of the consolidation. In fact, the banks are now being given their right to a hearing.

Within four months of the filing of the petitions in this court John D. Rasco, the corporate president, in behalf of River Road, delivered to Farmers and Traders Bank of Meredosia and Schuyler State Bank of Rushville an instrument purporting to mortgage two barges in the possession of the bankrupt. This mortgage was given, so the banks claim, to secure loans advanced to River Road between September 10 and September 21, 1970, which loans arose by virtue of the banks having credited River Road's account for checks that subsequently were dishonored. That the correct terminology for this advancement of credit on uncollected funds deposited in the banks was anything but a simple case of "check kiting" goes with little further comment. Their losses totalled \$300,000. At the Trustee's

sales, the barges brought some \$45,000. At the time the mortgage was executed the banks were aware of their losses. They loaned no new money. The mortgage was therefore given for an antecedent debt. The barges were incomplete, one in the water but only 95% completed, the other still in state of construction.

That the bankrupts were hopelessly insolvent at the time of the mortgage transaction is settled. John D. Rasco, the owner, had never contributed one dime of capital and there was no showing that any services he rendered in behalf of the corporations ever proved to be of any monetary value.

The trustee petitioned to sell the personal property herein, including the barges, and by order of this court, the Schuyler State Bank, among others, was ruled to show cause why the property should not be sold free of its lien, with its lien, if found valid, to attach to the proceeds thereof. The Meredosia Bank was not so ordered but appeared anyway at the hearing on the petition to sell to say it had no objection to the sale of the barges, "in that the said funds (therefrom) would not be expended until the determination of whether or not the mortgage" /sic/ of the banks "were valid liens on said motor vessels." Any inadequacy of notice here is waived by the Bank's voluntary appearance and submission to the Bankruptcy Court. The Schuyler Bank, by its silence, consented to the sale too, and nothing further was done with respect to the mortgage until the Trustee filed his final report, at which time the Banks took exception to the report and made claim to the funds in the Trustee's hands because of their mortgage.

To the exceptions the Trustee replied that the mortgage on the barges was a preference and therefore void. Thereafter an extensive hearing was held and briefs were filed as

to the rights to the money, in other words, the validity of the mortgage.

As between courts of coordinate jurisdiction the first one obtaining custody of the res is entitled to retain it and to determine validity of all liens thereon and to set aside those liens obtained within four months of bankruptcy. This court and not the Admiralty Court has the jurisdiction over the barges, and with the barges in its custody, has complete jurisdiction over those parties holding alleged liens on the barges. Whether the creditor has filed a secured claim is wholly immaterial. An alleged lienholder must respond to a show cause order or default. If he appears, the burden is upon him to prove his lien.

The Meredosia Bank and the Schuyler State Bank, both being in court, there is no application of two-year limitation of Section 11e of the Bankruptcy Act. It was not up to the Trustee to inquire, other than he did, by what right any alleged lienholders might claim money in his hands, but the lienholders' duty to come into court to prove up their secured claims. This they did, and I find that all requisites of a preference being present, the claims of the banks filed under the title of Reclamation Petitions are denied. Section 11e comes into play when a Trustee, for instance, seeks in a separate action to recover for the estate a preferential transfer of a res not in the jurisdiction of the bankruptcy court; but it does not come into play when he defends money in his hands from creditors whose claims would be preferential if successful.

Every preferred ship's mortgage (Title 46 U.S.C. 922) requires it be supported by an affidavit to be filed with it. The affidavit must recite that it is made in good faith and without design to hinder, delay or defraud existing or future creditors. Neither the grantor nor the grantees of

the mortgage could have made such an affidavit, for at the time of the execution of the mortgage all knew or should have known such a statement was in fact false.

While the Trustee did not press the validity of the mortgage in its execution, I should like to make my own comments thereon. The evidence supporting the execution is sketchy. There is no provision in the law that allows documenting as a U.S. vessel an uncompleted boat. Documenting presupposes a completed boat. For the purpose of trying desperately to save something for themselves, the banks hurriedly concocted a preferred ship's mortgage after causing a fraudulent documenting of the vessels. On this score, I find the mortgage void.

The \$170,000 claim of the Farmers and Traders State Bank of Meredosia is allowed as a general claim.

The \$130,000 claim of Schuyler State Bank is allowed as a general claim.

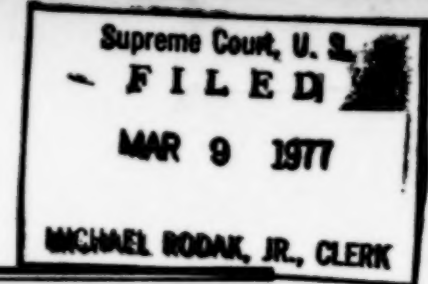
The objections of the two Banks to the final account of the Trustee are denied.

The Reclamation Petitions of the Banks are denied.

The Motion to Dismiss and for other relief filed herein November 20, 1973 by the Meredosia Bank is denied.

Entered: May 1, 1974.

/s/ Basil H. Coutrakon
Bankruptcy Judge



**IN THE
SUPREME COURT OF THE UNITED STATES**

OCTOBER TERM, A.D. 1976

No. 76-1082

Docketed February 4, 1977

IN THE MATTER OF:

**MEREDOSIA HARBOR & FLEETING SERVICE, INC.
and RIVER ROAD MARINE REPAIR, INC.**

**FARMERS & TRADERS STATE BANK
OF MEREDOSIA,**

Petitioner,

v.

**ROBERT M. MAGILL, TRUSTEE,
Respondent.**

**RESPONSE TO PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

**JAMES L. MAGILL
810 First National Bank Bldg.
Springfield, Illinois 62701
Attorney for Respondent**

**IN THE
SUPREME COURT OF THE UNITED STATES**

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**RESPONSE TO PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

STATEMENT OF THE CASE

John D. Rasco formed two corporations in 1970: Meredosia Harbor and Fleeting Service, Inc. and River Road Marine Repair, Inc. River Road Marine Repair, Inc. was a wholly owned subsidiary of Meredosia Harbor and Fleeting Service, Inc. The purpose of both corporations was to build

and repair boats. After having been incorporated, the corporations commenced construction on two river tow boats, the Mary Ann and the Anita Maria.

In early 1970, Mr. Rasco engaged in a fraudulent scheme to wrongfully obtain funds from the Farmers & Traders State Bank of Meredosia and the Schuyler State Bank of Rushville; said acts required the cooperation of officers of both banks. At the same time, Mr. Rasco opened accounts in Quincy, Illinois and Tulsa, Oklahoma. During the summer of 1970, he commenced kiting checks among the banks. The Meredosia Bank was aware of Rasco's check kiting as early as July 1970, and the Rushville bank realized, in early 1970, that Rasco was insolvent and in an overdraft position. The check kiting scheme was discovered by bank examiners who were auditing the Farmers and Traders State Bank of Meredosia in early September 1970. The Schuyler State Bank of Rushville suffered a loss of \$130,000 and the Meredosia Bank suffered a loss of \$170,000.

Mr. Rasco, as well as the two banks, knew that bankruptcy was imminent. In order to protect the bank's position, the bank attempted to acquire a perfected lien on the Mary Ann and Anita Maria, both of which were incomplete on October 1, 1970. Among the requirements for a perfected security interest in the two vessels, was that the mortgagor had to execute an affidavit stating that "the mortgage is made in good faith and without any design to hinder, delay or defraud any existing or future creditor of mortgagor or any lienor of the mortgaged vessel." Neither the mortgagor nor the mortgagee could have believed this to be true.

On November 6, 1970, the mortgagor, River Road Marine Repair, Inc. and Meredosia Harbor and Fleeting Service,

Inc. filed reorganization petitions under Chapter XI of the Bankruptcy Act. An adjudication of bankruptcy was entered on January 4, 1971. Ten days thereafter, the Trustee petitioned for leave to sell both unfinished vessels and other property of the consolidated bankrupts. On February 7, 1973, the Meredosia Bank filed an objection to the Trustee's January 2, 1973 final report, indicating that it had the maritime mortgage for the two vessels in the amount of \$300,000. In March 1973, the Meredosia Bank filed a petition to reclaim the vessel or the proceeds of their sale, and a similar reclamation petition was filed in June 1973 by the Rushville bank. The Trustee defended this position that the security interest transferred by the bankrupt to the bank constituted a preferential transfer under Section 60 of the Bankruptcy Act, Chapter VI, Section 96 of the United States Code, Title XI.

The bankruptcy court found that no valid lien existed whereby the bank could claim any right to the proceeds of the trustee's sale of the two vessels owned by the bankrupt, and that the bank's attempt to acquire a mortgage on said uncompleted vessels affected a preferential transfer under Section 60 of the Bankruptcy Act. The bankruptcy court's decision was affirmed by U.S. District Court for the Southern District of Illinois, and the opinion of the district court was affirmed by U.S. Court of Appeals for the Seventh Circuit.

ARGUMENT

The argument presented by the bank in its petition to this Court for review can be summed up as follows:

When perfection of a mortgage requires an affidavit of good faith that the affiant is not attempting to hinder his other creditors, said good faith need not be present on the part of the mortgagor or mortgagee as long as the mechanics of executing the required affidavit are followed.

Reference is made to the opinion of the United States District Court wherein nine factors are listed indicating that the good faith requirement could not have been fulfilled. (Petitioners supplement to Petition for Certiorari, P. 14.)

Petitioner uses extensive space in discussing the efficacy and importance of admiralty law generally. Petitioner further states that this is an area in which there is no guidance by statute or case and that therefore this Court should establish the law for facts such as those presented herein.

The efficacy of admiralty law in the United States is not at issue as petitioner would attempt to lead this Court to believe. When the constructs of the statute outlined in the steps for perfecting a mortgage are followed, said mortgage is given preferential status and such status is appropriately honored in the Bankruptcy Court. However, where those constructs are not followed, the protection supplied by the statute cannot be made beneficial to any debtor or creditor. In the present case, there was no good faith affidavit because there could be no good faith affidavit. The undisputed evidence in the case, as explained in the opinion of the Court of Appeals, is that both parties

knew that the mortgages would be taken to the detriment of other creditors. It is the Trustee's position that in fact to uphold the petitioner's position that no good faith need be present in signing an affidavit of good faith would weaken the Ship's Mortgage Act to a great extent rather than strengthen it as petitioner proposes.

CONCLUSION

For the foregoing reasons, Trustee respectfully submits that the questions presented by petitioners are clearly insubstantial, and that the judgment of the district court should be affirmed.

Respectfully submitted,

JAMES L. MAGILL
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Springfield, Illinois 62701
Attorney for Respondent